

Chapter 9 — Accounting for Receivables

FREE chapter notes · companion to the video lecture · optionflowtracker.com

Watch the full video lecture on YouTube: youtube.com/@optionflowtracker — these notes follow the chapter section by section, with the same ideas and the same numbers, so you can read along or revise after watching.

1 · The three kinds of receivables

A receivable is a claim to cash the company expects to collect. Chapter 9 is about two big ones — the money customers owe, and formal promissory notes — plus how to handle the reality that some customers never pay.

Accounts receivable: Amounts customers owe from buying goods or services on credit. Usually collected within 30–60 days; a current asset.

Notes receivable: A written promise (a promissory note) that a customer will pay a set amount plus interest on a specified date. Stronger than an account because it is a formal, interest-bearing instrument.

Other receivables — interest receivable, loans to employees, tax refunds — are reported separately. The two that drive this chapter are accounts and notes receivable.

2 · Recognizing accounts receivable and credit card sales

A sale on account debits Accounts Receivable and credits Sales Revenue; collecting it later debits Cash and credits Accounts Receivable (no new revenue). Two credit-card situations add a twist.

- Company (in-house) credit card — the company carries the receivable itself and can charge interest on unpaid balances: debit Accounts Receivable, credit Interest Revenue.
- National bank card (Visa, MasterCard) — treated essentially like a cash sale, minus a processor fee. Record the fee as Service Charge Expense.

A bank-card sale with a fee. A store makes \$4,500 of Visa sales with a 2% processor fee. The fee is $4,500 \times 2\% = \$90$, so it debits Cash \$4,410 and Service Charge Expense \$90, and credits Sales Revenue \$4,500.

3 · The problem of uncollectible accounts

Selling on credit means some accounts will never be collected. The question is when and how to record that expense. There are two methods.

- Direct write-off — record Bad Debt Expense only when a specific account is judged worthless. Simple, but it often records the expense in a later period than the sale, violating the matching (expense recognition) principle. Allowed only when uncollectibles are immaterial.
- Allowance method — estimate uncollectibles each period and match that expense to the same period as the sales. Required by GAAP when bad debts are material.

4 • The allowance method

The allowance method records an estimate of bad debts with an adjusting entry at period end, before anyone knows exactly which customers will default.

Allowance for Doubtful Accounts: A contra-asset account paired with Accounts Receivable. Its credit balance represents the portion of receivables not expected to be collected.

Net realizable value: Accounts Receivable minus the Allowance for Doubtful Accounts — the amount the company actually expects to collect.

The estimating entry. The adjusting entry always takes the same form: debit Bad Debt Expense and credit Allowance for Doubtful Accounts. If Accounts Receivable is \$500,000 and the Allowance is \$30,000, net realizable value is \$470,000.

5 • Estimating bad debts: percentage-of-sales

The percentage-of-sales (income-statement) approach emphasizes matching. It applies a percentage to net credit sales to get the bad debt expense directly.

- $\text{Bad Debt Expense} = \text{net credit sales} \times \text{the estimated percentage}$.
- The existing balance in the Allowance account is IGNORED — the computed amount is the expense.

Percentage-of-sales. Net credit sales are \$800,000 and 1% is expected to be uncollectible. $\text{Bad Debt Expense} = 800,000 \times 1\% = \$8,000$. Record: debit Bad Debt Expense \$8,000, credit Allowance for Doubtful Accounts \$8,000 — regardless of the allowance's current balance.

6 • Estimating bad debts: percentage-of-receivables (aging)

The percentage-of-receivables (balance-sheet) approach emphasizes net realizable value. Often done with an aging schedule, it estimates the TARGET balance the Allowance account should have — then adjusts to reach it.

- An aging schedule sorts receivables by how overdue they are and applies a higher percentage to older buckets.
- The result is the desired ENDING balance of the Allowance account.
- $\text{Bad Debt Expense} = \text{target allowance} - \text{existing CREDIT balance (or + an existing DEBIT balance)}$.

Aging with an existing balance. An aging schedule estimates \$10,000 of receivables will be uncollectible. The Allowance already has a \$1,500 credit balance, so the entry only needs to add \$8,500: debit Bad Debt Expense \$8,500, credit Allowance for Doubtful Accounts \$8,500, bringing the allowance to the \$10,000 target. (If the allowance instead had a \$500 DEBIT balance, the expense would be $10,000 + 500 = \$10,500$.)

7 • Writing off and recovering accounts

When a specific account is finally deemed worthless, it is written off against the allowance — not to expense (the expense was already estimated).

- Write-off — debit Allowance for Doubtful Accounts, credit Accounts Receivable. This has NO effect on net income or on net realizable value (both AR and the allowance drop by the same amount).
- Recovery — if the customer later pays, first reverse the write-off (debit Accounts Receivable, credit Allowance), then record the collection (debit Cash, credit Accounts Receivable). The claim survives; it's just no longer a note.

A write-off. A \$2,000 account is judged uncollectible: debit Allowance for Doubtful Accounts \$2,000, credit Accounts Receivable \$2,000. Net realizable value is unchanged, because the allowance already anticipated the loss.

8 • Notes receivable and computing interest

A promissory note has a maker (who promises to pay), a payee (who will receive), a face value (principal), an interest rate, and a term. The one formula you must know cold:

Interest formula: Interest = Face value x Annual interest rate x Time. Time is expressed as a fraction of a year — months ÷ 12, or (for day-based notes) days ÷ 360.

Computing interest. A \$6,000, 3-month, 8% note earns interest of $6,000 \times 8\% \times 3/12 = \120 . A \$10,000, 60-day, 9% note (360-day year) earns $10,000 \times 9\% \times 60/360 = \150 .

If a note spans a period-end, accrue the interest earned so far: debit Interest Receivable, credit Interest Revenue for the portion earned.

9 • Honored and dishonored notes

At maturity a note is either honored (paid) or dishonored (not paid).

- Honored — the maker pays face value plus interest. Debit Cash for the total, credit Notes Receivable for the face value, and credit Interest Revenue for the interest.
- Dishonored, but collection still expected — transfer the amount owed to Accounts Receivable: debit Accounts Receivable for face plus interest, credit Notes Receivable and Interest Revenue. The claim survives; it's just no longer a note.

A honored note. A \$6,000, 3-month, 8% note is paid at maturity. Interest is \$120, so debit Cash \$6,120, credit Notes Receivable \$6,000, and credit Interest Revenue \$120.

10 • Analyzing receivables

Two ratios tell how quickly a company turns receivables into cash.

Accounts receivable turnover: Net credit sales ÷ average net accounts receivable. It measures how many times, on average, receivables are collected during the period.

Average collection period: $365 \div$ accounts receivable turnover — the average number of days it takes to collect a receivable. Compare it to the credit terms to judge collection efficiency.

Turnover and days. Net credit sales of \$900,000 and average net receivables of \$90,000 give a turnover of 10 times. The average collection period is $365 \div 10 = 36.5$ days.